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Economic Growth and Federal Reserve Policy

Just a month ago we marked the first anniversary of the New Economic Program, a dramatically new departure in Government economic policy. The effect of that program is written clearly in the whole spectrum of economic data which have become available since last August. The pattern that emerges is clearly one of sustained economic growth, accompanied by an encouraging reduction of inflationary pressures.

In terms of output, there has been clear evidence of improvement. Since the third quarter of 1971, Gross National Product--the total output of goods and services of the economy--has increased in dollars of constant purchasing power at an annual rate of 7 1/2 percent. Industrial production has climbed at about the same clip. At the same time the GNP price deflator--the nation's overall price index--has slowed its advance from almost a 4 1/2 percent annual rate increase over the first three quarters of 1971 to about a 3 percent rate of increase since then. Certain uncontrolled prices--and meat prices obviously head the list--have grown more rapidly. But in most cases this reflects rapid increases in consumption in the face of supplies that cannot be expanded quickly.

So far, the sectors most responsible for the upturn in economic activity have been housing, automobiles and other consumer durables. Inventory investment and new plant investment have lagged until very recently--and they are still somewhat sluggish.

There has also been progress on the employment front. The rate of unemployment remains unacceptably high, however. As you know, the unemployment rate was sticking around 6 percent for much of the period since August 1971 and did not decline to its current level of about 5 1/2 percent until May of this year. But employment has been increasing--with total payroll employment up by more than 2 million in the past year.

And we've made some progress on the international side too. The balance of payments situation has improved markedly from the record high deficit registered in the third quarter of 1971. But the current deficit remains unacceptably large and the balance of trade remains negative even after the currency exchange rate adjustments earlier this year. Nevertheless, I continue to be optimistic. The Smithsonian agreements created a satisfactory intermediate solution and the need for further action has been recognized throughout the world. The commitment to negotiate a new, long-lasting monetary structure has been made, and even though the negotiations will be long and complicated, I am confident about their eventual success.

Accompanying the marked improvement in the domestic economy, we have seen--through this summer--relatively tranquil money markets in terms of interest rates and acceptable monetary growth performance in terms of the aggregates talked about these days such as the narrowly defined money supply--demand deposits and currency in the hands of the public. Thus far in 1972, the Federal Reserve System hasn't been getting much "static" from the monetarists--those who feel we should have a constant rate of money supply growth. Nor have we been getting much "static" from those who focus almost entirely on interest rates as the best guide to monetary policy formulation.

There haven't been many times when we've been so fortunate! Maybe we're doing something right. Conversely, I hope this period of tranquility doesn't mean everyone is misjudging the situation.

There is no question that we have learned something from the experience of the 1960's. The period from early 1961 to the end of 1969 may have been the longest period of continued economic growth of our history. But I for one refuse to call that period "the good old days." Certainly by most measures it was a period of remarkable economic performance. Nevertheless, we should not forget that during the first half of this expansion, although prices were very stable, unemployment averaged about 5 1/2 percent--just where it is today. In the latter half of the period, despite the accelerating demands of the Vietnam War, with its pressure on both manpower and other productive resources, we initiated the expansionary Great Society programs, thus starting an inflationary cycle so strong that subsequent tax increases failed to stem it.

Immediately after the Nixon Administration took office in 1969, it pinpointed inflation as the primary economic problem. It initiated a number of policy steps on the assumption that, by an extended period of slower economic growth, the rate of inflation could be reduced to an acceptable level without increasing unemployment to a level which would produce significant hardship. It was realized that this would be a lengthy process. Yet I know of no economist, in or out of government, who did not underestimate the powerful upward momentum built into the trends of both prices and wages. Despite the policy steps which had been taken, expansion of business activity continued, and inflation, as measured by the change in the consumer price index, was at its peak during the year 1969.

By the beginning of 1970, real growth in national output was near zero. Production was expected to revive at a moderate rate during the second half, with continued slowing of the rate of price increase. But these expectations were frustrated by the depressing effect of the auto strike and the dislocations caused by the slowdown in military expenditures and the substantial reduction of the size of the armed forces. Despite the fact that the unemployment rate climbed above 6 percent, continuing price and wage pressure produced an increase in the consumer price index only slightly smaller than the previous year. Nevertheless, progress against inflation had been made without the severe unemployment which occurred in 1957-58, and the impact on primary family breadwinners was significantly less severe.

Except for the immediate recovery after the end of the auto strike, the rate of growth in the economy remained sluggish through the first half of 1971. We all obviously underestimated the pressures which had accumulated--pressures that caused a persistent inflationary spiral in the face of a 6 percent unemployment level and reduced growth in output over a long period. It is true, by mid-1971, the rate of inflation had been reduced somewhat from its 1969 rate of 6 1/2 percent, but it was still much too high. It was clear that we had to accept many more months of substandard economic performance if we were to reduce inflation by conventional policy approaches. This meant that either a more drastic approach had to be taken, or we would have to pay for our past excesses with a prolonged period of 6 to 7 percent unemployment. This was a price the President was unwilling to ask the nation to pay if another path was available. That path was found in the wage and price control program as a necessary supplement to--but <u>not</u> a substitute for--the more traditional tools of fiscal monetary policy.

As I said earlier, I think we've learned something from the 1965-71 experience. Few observers would dispute the conclusion that the record of both monetary and fiscal policy from 1965 to 1968 left something to be desired although its performance in 1969 through 1971 was--belatedly--much better. Those charged with the responsibility for making public policy decisions are attempting to learn from the errors of that period. I still have some reservations about the ability and willingness of the Congress to maintain firm control of its part of the Federal budgetary process but I am reasonably confident about the role which Federal Reserve policy can continue to play.

In their efforts to improve their understanding of the workings of the economic system and the policy instruments at their disposal, monetary policy makers have been assisted by recent developments in the field of economics. In particular, I am referring to the knowledge and analysis that have grown out of the protracted and as yet unresolved debate between the "Keynesians" and the monetarists which was renewed in earnest about 1963.

As you all know, Professor Milton Friedman has long been an advocate of the view that the behavior of the money supply has a causal effect upon the behavior of economic activity, and that monetary effects far outweigh fiscal policy effects. Professor Friedman has long argued also that we do not know enough about the links between changes in the money supply--narrowly defined as demand deposits and currency in the hands of the public--and changes in income to be able to employ discretionary monetary policy effectively. He reasons, therefore, that money should grow at a relatively steady rate in order to stabilize the rate of growth of other economic variables.

The "Keynesians," unlike the monetarists, argue that fiscal policy does have a significant impact upon real economic activity quite independent of monetary changes so long as unemployed resources exist. Otherwise, they agree with the monetarists that increased government expenditures must "crowd-out" private expenditures via rising interest rates and/or price inflation. The Keynesians also argue that income or (wealth) systematically determines consumption spending, and that income is affected largely by changes in investment behavior. Since it is assumed that investment is stimulated or restricted by changes in the cost of capital or interest rates, the more important effects of monetary policy are viewed as being the effects upon interest rates.

Within the Federal Reserve System neither view is accepted completely by those involved in the policy process. The reason is simple. Our economy is not only large but extremely complex. Some may argue that this explanation is a "cop out" (in the vernacular of today) but the fact remains that we simply don't know everything about the structure of the economy and how it adjusts to fluctuations in both real and financial behavior.

Within the Federal Reserve System both the monetarist and Keynesian views are considered seriously. Both views have, in fact, been formalized in econometric models. Both of these models have proven useful in constructing the forecasts needed for making monetary policy decisions. I hasten to add that models can never be relied upon exclusively in forecasting. Yet they are a very helpful supplement to the judgmental projection procedures which have been the mainstay of the forecasting activities in the System over the years. They are particularly useful in evaluating the likely effects of choosing differing policy alternatives. This is achieved by running the models under a variety of assumptions concerning monetary policy.

Other than as forecasting and simulation aids, these models and other studies completed since the mid-1960's have had other important effects upon thinking within the Federal Reserve System and elsewhere. Although the models are not sufficiently precise that they can be relied upon for forecasting without qualitative reservations, they have appropriately focused attention on many important considerations that were not taken into account systematically in the past.

Perhaps the most important conclusion to be drawn from these research efforts is that monetary policy cannot ignore the behavior of monetary aggregates--whether defined as demand deposits and currency in public hands commonly called M_1, or that figure plus time deposits (other than large Certificates of Deposits) called M_2, or bank credit.

With respect to a second very important question, the length of time required for monetary policy actions to affect income, the results are quite inconclusive. The evidence we do have strongly suggests that lagged response is important, but whether the lags are a few months or one, two or more years in length is uncertain at this point. The existence of lags implies that monetary policy deliberations should encompass a time horizon sufficiently long to include lagged effects of policy changes on economic activity. Lagged response also implies that monetary policy makers should not expect to be able to bring about significant changes in, or maintain close control over, economic activity in the short run. And also, where lags exist, frequent abrupt policy changes greatly increase the risk of interpreting disturbances in the economy arising from the lagged effects of past policy changes as changes in underlying economic behavior.

In addition, economic analysis in recent years suggests that the initial conditions in the economy--that is, where the economy happens to be in the economic cycle--affect the response of the economy to policy changes. One example is the contention that expansive fiscal policy affects real output when there are idle resources, but affects prices and "crowds-out" private investment when resources are fully employed. Another example is the likely impact of expansive monetary policy upon price expectations. At a cyclical trough, much less of an impact might be expected on price anticipations than at a cyclical peak.

Further, there are uncertainties in every economic environment. We do not have the ability to explain economic behavior precisely in our analyses at any point of time. Economic behavior is subject to change over time. And there is an important random element in economic behavior which becomes more important (or troublesome) the shorter the time period that is considered.

I cite all of these difficulties not out of a sense of frustration or a "know-nothing" view but rather to emphasize the nature of the so-called monetary control problem. Because of uncertainties of various types, our decision process must gauge these uncertainties and the attendant risks.

It is well known that the ultimate goals of monetary policy involve the behavior of employment, prices, economic growth and international equilibrium. But, monetary policy does not affect these ultimate goal variables directly with sufficient speed for purposes of policy making, so it is necessary to select intermediate goals that the Federal Reserve can attain relatively quickly and more directly. When the uncertainties associated with economic behavior are taken into account, available analysis supports the conclusion that the choice of the intermediate goal--for example, the money stock or interest rates--depends upon where the greatest degree of uncertainty lies.

If monetary or financial behavior is less predictable--or more subject to unforeseen variation--then it is preferable to pursue an intermediate goal framed in terms of interest rates in order to stabilize investment, consumption and income. If, on the other hand, the real sector of the economy--investment for example--is more subject to unpredictable variation, then a monetary aggregate intermediate goal is preferable.

There is little question that the Federal Open Market Committee has moved further in the direction of emphasizing monetary aggregate behavior as an intermediate goal of policy. In part, the choice is a matter of subjective judgment but it is supported by the results of available studies. At the present time, the intermediate goals of the Federal Open Market Committee are generally in terms of three monetary aggregates, the narrowly defined money stock, M_1, the more broadly defined money stock including some time deposits, M_2, and total bank credit. Time does not permit a discussion of the reasons for choosing three monetary aggregates rather than one. Suffice it to note that greater attention may be paid to one or two of these aggregates at particular times because they do not always move together for a variety of reasons.

Even though the Federal Reserve System generally has intermediate goals framed in terms of M_1, M_2 or bank credit, we all must remember that these aggregates are not under the direct control of the Federal Reserve. Consequently, for operational purposes it is necessary to translate these intermediate goals into operational targets to be used by the Manager of the System Open Market Account in New York. This operational target must be related closely to the intermediate goals, and the behavior of the target must be known to the manager of the trading desk quickly, since it is a major determinant of his day-to-day operations in the government securities market.

Currently, this operating target, as some of you may know, is reserves against private nonbank deposits--RPDs. Based on many of the commentaries I have seen on RPDs, it appears that our purpose may have been misinterpreted. This is not an attempt to achieve close control over the behavior of a single monetary aggregate to the exclusion of other considerations. Certainly the choice was related to considerations as to which possible operating target would yield the best control over the intermediate monetary aggregate goals. But short-term rates and money market conditions are not ignored. Within the Federal Reserve System there is strong sentiment that sharp fluctuations in short-term interest rates and other money market conditions should be avoided whenever possible. It is felt that smooth, gradual changes facilitate planning by market participants and avoid the generation of erroneous expectations or misinterpretations of the intent of the monetary authority. At the same time, policy makers are aware that too rigid controls of money market conditions would mean loss of control over intermediate goals.

Consequently, the Federal Open Market Committee has agreed to specify its operating target in terms of RPDs, but subject to constraints upon the degree and rapidity of movement of money market conditions between our monthly Federal Open Market Committee meetings.

RPDs used in this way serve as a compromise--an umbrella if you please--under which the various views of the monetary process can be adequately synthesized as instructions to the open market manager. The decision makers are not forced to put all their eggs in an interest rate or an M_1 basket, ignoring other risks and uncertainties, but can translate their evaluations into a common instruction language with desired constraints.

It should be noted that in addition to these technical factors, the Federal Reserve System operates within another set of broader social constraints. At times, one or more of the ultimate goals involving employment, prices, economic growth and international considerations cannot be achieved. When this occurs, the System cannot set out to rectify the situation without taking into account the effects on other goals. For example, in 1969 it was clear that price behavior in an inflationary environment was unacceptable. But monetary policy could not be employed with sufficient restrictive force to achieve acceptable price behavior in a short period of time. Such actions would have resulted in a clearly unacceptable level of unemployment.

Another significant constraint involves the fiscal policy of the Federal Government. By the nature of the budgetary process and the deathlessness of many Federal programs, there is very little flexibility in government expenditures over short periods of time. Therefore, if expenditure decisions are not matched by equivalent revenue sources, the Treasury has no recourse but to issue additional debt. When this occurs, the Federal Reserve System frequently has little choice to help the Treasury along if financial market difficulties loom on the horizon. Such action then means a blunting of control over monetary aggregate behavior.

Fiscal policy has important lags too, and it is extremely difficult for the Government--particularly the Congress--to change directions, or even to change pace.

And the future path of fiscal policy raises important questions as we look at the outlook here today. We have clearly established a solid base for economic growth. The first half GNP figures for 1972 highlight this. The momentum generated by this good performance is showing up throughout the economy. The continued level of housing starts at well above the 2 million level assures a high level of residential construction activity for the next several months. It also appears in the data on orders and backlogs. Both have been rising since September, 1971. New orders for durable goods are almost 20 percent above the level of the second quarter of 1971 and backlogs have risen about 6 percent as shipments have fallen behind the pace of orders. And the recent retail sales figures show a continuing willingness of the consumer to do his share in fostering growth.

Thus, as we look at the current economic situation, the evidence points to a balanced sustained growth through 1972 and on into 1973. Yet we cannot ignore the possibility of greater inflation next year than this. As business conditions continue to improve, demand pressures will begin to be exerted on prices. At the same time, negotiations for a broad range of labor contracts are coming up next year. If prices have risen, it will be very difficult to restrain wage increases to levels which do not, in turn, put further pressure on prices. These are pressures which arise in every period of economic growth. The problem is more than usually acute at this particular time. We have made progress in the dumping of the inflation of the past several years. But the battle is still not won. Given the private sector alone, there is a good chance that the battle could be won. The slack remaining to be taken up in productivity and in employment still provides considerable leeway to exert enough countervailing pressure on prices and wages to keep wage and price controls operative.

But we do not have only the private sector to deal with. The real key to whether we can achieve continued growth with stable prices lies in the hands of the Federal Government. Recurring deficits in the Government sector as the economy approaches full employment can lead to only one result--renewed inflation.

I am deeply concerned about the longer-term implications behind present expenditure trends--expenditures running ahead of full employment revenues. I am concerned, first, because we seem to have developed a strong tendency to expand Federal spending without providing the taxes to finance that spending. My second concern is that we have increasingly developed programs which incorporate automatic, usually accelerating, spending in future years, so that a larger and larger share of Federal expenditure is predetermined, without much control by either the Congress or the Executive.

The Congress, in particular, needs to take some action to regain control of its part of the budgeting process. A bipartisan resolution has recently been introduced in the House which would prevent consideration of any appropriation bill until an overall budget had been agreed to, both in terms of total size and in distribution by appropriation categories. Once this overall budget was set, any appropriation exceeding the budget allotment would require a two-thirds majority for passage. Such a step would certainly be a move in the right direction.

An excellent argument can also be made for the establishment by the Congress of a Joint Committee on the Budget to provide the Congress with an independent view of the whole budgetary picture and with the analytical capability now only available to the Executive Branch. Federal Reserve Chairman Burns, in recent testimony before the Joint Economic Committee, urged that Congress give careful consideration to this suggestion.

In the absence of these or some other constraints on our willingness to spend without the accompanying taxation, we are certainly faced with the rekindling of the inflation which we have just spent three difficult years bringing under better control. I am confident that monetary policy is up to the task of helping to keep control. But not alone. The seeds have been planted for a significant period of stable economic growth. How we handle the threat of renewed inflation will determine the yield at harvesttime.